



OVERVIEW OF THE 2005-06 BUDGET BILL

Senate Bill 52

As Introduced

Senate Committee on Budget and Fiscal Review
Senator Wesley Chesbro, Chair

January 2005

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January 26, 2005

Dear Colleague:

I am pleased to forward a copy of the *Overview of the 2005-06 Budget Bill* prepared by the staff of the Senate Budget and Fiscal Review Committee.

In the first section, we provide an overview of the state's fiscal condition. The next section, entitled "Budget Highlights," is organized by subcommittee, and details the budget for most departments and agencies. If you are looking for a specific department or agency, there is an index at the end of the highlights section.

In the Appendix, we include a working timeline for completing the budget and a list of assignments for the budget committee consultants.

If you have questions, please call me.

Sincerely,

A handwritten signature in black ink that reads "Wesley Chesbro". The signature is fluid and cursive, with a large, stylized "W" and "C".

WESLEY CHESBRO
Chair

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SETTING A CONTEXT

Once again the state is facing a major budget challenge. To effectively address the problem, the Legislature will have to consider the proposals made by the Administration, but also weigh a variety of other options to fully address California's budget shortfall; including, but not limited to, maximizing the receipt of federal funds, reviewing and eliminating tax loopholes that may not be achieving their intended purpose, and creating program efficiencies wherever possible.

In addition, the Governor has called a Special Session of the Legislature to deal with various proposals including major budget and pension changes. One component of the Governor's proposals would severely diminish the Legislature's appropriation authority by requiring automatic across-the-board reductions without regard to legislative priorities. Other components of the Governor's proposals actually eliminate current budgetary mechanisms available to help balance the budget.

In early February, the Senate Budget and Fiscal Review Committee will begin its regular subcommittee hearing process, which will conclude shortly after the Governor releases his May Revision to the Budget on or before May 14, 2005.

GOVERNOR'S PROPOSED 2005-06 BUDGET

Proposed Total State Spending for 2005-06. Total spending proposed for 2005-06 from all funds (General Fund, special funds, and bond funds) is \$111.7 billion. General Fund expenditures are estimated to be \$85.7 billion; special fund spending is approximately \$23.3 billion, and selected general obligation bond fund expenditures are \$2.7 billion.

General Fund Summary

Revenues: The Governor's budget estimates General Fund revenues and transfers to be \$83.8 billion, an increase of \$5.6 billion, or 7.1 percent, above the revised 2004-05 estimate of \$78.2 billion. Total resources available, in 2005-06, from all sources (including economic recovery bonds) are estimated at \$86.9 billion.

Expenditures: The budget proposes General Fund expenditures of \$85.7 billion in 2005-06. This is an increase of \$3.4 billion, or 4.2 percent, over the revised 2004-05 figure of \$82.3 billion.

General Fund Summary		
(in millions)	2004-05	2005-06
PRIOR YEAR BALANCE	\$3,489	\$1,425
Revenues	77,904	83,227
Transfers	315	544
Economic Recovery Bonds	<u>2,012</u>	<u>1,683</u>
TOTAL RESOURCES AVAILABLE	\$83,720	\$86,879
Non-Proposition 98 Expenditures	\$48,171	\$49,206
Proposition 98 Expenditures	<u>\$34,124</u>	<u>\$36,532</u>
TOTAL EXPENDITURES	\$82,295	\$85,738
FUND BALANCE	\$1,425	\$1,141
Encumbrances	\$641	\$641
General Fund Reserve	\$784	\$500

General Fund Revenue By Source			
(in millions)			
Source	2004-05	2005-06	Year-to-Year Percent Change
Personal Income Tax	\$39,527	\$42,895	8.5
Sales Tax	25,168	26,947	7.1
Corporation Tax	8,678	\$9,015	3.9
Other	4,846	\$4,915	1.4
TOTAL	\$78,219	\$83,772	7.1

Proposed 2005-06 General Fund Expenditures
(in millions)

Major Program Area	2004-05	2005-06	Year-to-Year Percent Change
Education – Proposition 98 (K-12 / Community Colleges)	\$34,124	\$36,532	7.1
Health and Human Services	25,519	26,689	4.6
Higher Education (UC/CSU/Other)	7,912	8,589	8.6
Youth and Adult Corrections	6,897	6,980	1.2
All Other	<u>7,843</u>	<u>6,948</u>	<u>-11.4</u>
TOTAL	\$82,295	\$85,738	4.2

Definition of the Problem. The Governor's proposed budget identifies an accumulative General Fund deficit, the difference between revenues and expenditures for the two-year period ending on June 30, 2006, or \$9.1 billion. This figure also includes a projected year-end General Fund reserve of \$500 million.

How Does the Governor Close the Gap? The Governor's budget, in order to bridge the gap between revenues and expenditures, relies to a large extent on loans and deferrals to balance the budget. The major components of the Governor's budget solution are:

- Utilizing approximately half (\$1.7 billion) of the remaining Economic Recovery Bonds. This would leave approximately \$2 billion of unused bond authority out of the \$15 billion of Economic Recovery Bonds authorized by Proposition 57.
- Suspending Proposition 42, in order to generate General Fund savings of \$1.3 billion. Repayment of the suspended amount would be due within a 15-year period.
- Maintaining the current-year level of Proposition 98 funding at the amount provided in the 2004 Budget Act, estimated to save \$2.3 billion over the two-year period.
- Proposing reductions to various programs in health and human services of approximately \$1.2 billion. Total CalWORKs reductions account for over \$653 million of the solution in this area, which includes grant reductions and elimination of cost-of-living adjustments.
- Proposing reductions in general government of \$928 million. A large portion of proposed savings in this area are the result of employee compensation changes (primarily from an increase in state employees' share of annual retirement contribution) for \$408 million in anticipated savings; \$136 million in savings is derived from eliminating the Senior Citizens' Property Tax Assistance Program and limiting eligibility for the Senior Citizens Renters' Tax Assistance Program.

- Reducing funding for resources by \$475 million. A recent court decision (*Paterno v. State of California*) found the state facing increased liability for the structural integrity of the aging levee system in the Central Valley. The Governor proposes to finance a pending \$464 million General Fund settlement of flood-related litigation against the state by issuing a judgment bond in the budget year.
- Proposing across-the-board reductions in departments of \$150 million. The budget proposes to give departments flexibility to use lay-offs, hiring freezes, procurement reductions, or other administrative means to achieve these reductions.
- Adjusting revenues by \$409 million -- the largest adjustments are from: (1) Public Transportation Account spillover revenues of approximately \$216 million and (2) additional funding available as a result of increased Tidelands Oil revenues of approximately \$121 million.
- Proposing reductions in Youth and Adult Correctional Agency of \$292 million.
- Proposing reductions in the non-Proposition 98 portion of the education budget of \$453 million -- primarily from the elimination of state contributions to the State Teachers' Retirement System.

GOVERNOR'S SPECIAL SESSION BUDGET PROPOSALS

The Governor has called the Legislature into special session to consider and act on various proposals. One of the proposals would change the budget process and has implications in various programmatic areas including pensions, transportation funding, and Proposition 98 (K-14 education) funding.

The budget indicates that the Governor will present a broad set of budget reforms to place on the ballot as constitutional amendments. The major elements of his proposal include the following:

- **Automatic Across-the-Board Cuts.** If General Fund revenues decline or General Fund expenditures exceed budgeted estimates by \$250 million or more (adjusted annually for inflation), the Governor must call a special session of the Legislature to remedy the imbalance. If legislation is not enacted within 45 days (30 days if the budget has not been enacted), the State Controller would have to make across-the-board reductions in General Fund payments to all programs, with the exception of debt service and payments required by federal law, in a percentage amount determined by the Department of Finance. The across-the-board reductions would remain in place until the Governor declares resolution of the fiscal emergency.
- **Continuing Appropriation When Budget is Late.** When a budget has not been enacted by July 1, expenditure authority at the prior-year levels would continue subject to the same conditions that applied for that prior-year budget. This would remain in effect until a new budget is enacted.

- **Prohibition of Loans and Repayment of Loans.** Starting with the 2006-07 fiscal year, prohibition of new borrowing from special funds is activated and requires repayment of any existing special fund loans within 15 years. This prohibition would not apply in the case of short-term loans that are necessary to meet the state's short-term cash flow needs if repayment is made within the same fiscal year or within 30 days of enactment of the budget for the next fiscal year.
- **Payment of Mandated Cost Deferrals.** Extends the payment period to 15 years for approximately \$1 billion of past local government claims for mandated costs reimbursements. Current law requires payment of these claims by 2011-12.
- **Proposition 98 Education Funding.** Reduces required state funding of K-14 education under Proposition 98. The "base" funding requirement for Proposition 98 in the future would be reset at the 2004-05 appropriation level, which reflects suspension of the Proposition 98 funding requirement in the current year. Beginning in 2006-07 authority to suspend Proposition 98 would be eliminated.

The Administration proposes to eliminate the "Test 3" funding option under Proposition 98. This includes the "maintenance factor" whereby reduced funding under the Test 3 formula must be paid back in future years. The "Test 3" is used to reduce the growth rate of Proposition 98 funding in low revenue years. For 2005-06, the "maintenance factor" is approximately \$3.7 billion. The state's current "maintenance factor" obligation would be converted to a one-time cash obligation to be paid to K-14 education over 15 years, rather than a gradual increase in the ongoing funding base.

Any future "settle-up" obligations will have to be identified within 24 months and the amounts would be continuously appropriated. Finally, any appropriations in excess of the Proposition 98 minimum guarantee will not be rolled into the ongoing funding base.

- **Proposition 42 Transportation Funding.** The Governor's proposal eliminates the suspension authority for Proposition 42 transportation funding with the 2007-08 fiscal year and requires repayment of all past suspension amounts over a 15-year period, with authorization for the state to bond out this obligation.
- **Pension Changes.** The Governor proposes a constitutional amendment that prohibits state and local governments from offering defined benefit plans to new employees. New employees would be enrolled in defined contribution plans, similar to 401 (k) programs, with public employees making fixed annual payments.

STATUS OF CURRENT-YEAR (2004-05) BUDGET

In July 2004, the Legislature enacted the 2004 Budget Act (SB 1113, Chapter 208, Statutes of 2004). The 2004 Budget Act addressed a General Fund shortfall of roughly \$16 billion. As enacted, the budget included a General Fund reserve of approximately \$768 million. The Budget Act, and its implementing legislation, contained a number of budget-balancing solutions, including, but not limited to:

- The use of Economic Recovery Bonds (approved by the state electorate as Proposition 57 in March 2004);
- A diversion of local property taxes;
- Suspension of Proposition 98;
- Some targeted revenue increases and tax loophole closures;
- Other loans and borrowing – primarily in the form a Proposition 42 loan, and from the proceeds of pension obligation bonds financed by a temporary reduction in payments to the Public Employees' Retirement System;
- Program savings – including three-month delays in cost-of-living adjustments for California Work Opportunity and Responsibility to Kids (CalWORKs) and Supplemental Security Income/State Supplementary Payment (SSI/SSP) grants, and reductions in support for the University of California and California State University; and
- Reductions in state operations spending.

Since the budget's enactment, the state's economy continues to grow at a moderate pace. According to the Department of Finance revenue expectations have improved since the 2004 Budget was enacted. Revenue estimates for 2004-05 have increased to a total of \$78.2 billion, or \$1.2 billion greater than previously estimated. Total resources available (including the use of economic recovery bonds) are estimated to be \$83.7 billion.

However, the DOF estimates that revised current-year expenditures have also increased to approximately \$82.3 billion. The Legislative Analyst indicated in her November forecast that increased current-year expenditures are the result of caseload increases, and in some instances, because the amount of savings resulting from various budgetary solutions are falling short of estimates.